URBAN AND ENVIRONMENTAL SERVICES PROJECT
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ENHANCEMENT OF FINANCIAL MANAGEMENT AND INTERNAL CONTROL SYSTEMS

FONDS D'EQUIPEMENT COMMUNAL

Final Report

Prepared For:

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The Office of Environment and Urban Programs

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EXECUTIVE SUMMARY

Introduction

This report is based on interviews with FEC officials during the period June 2 to June 11, 1997 and discussions of findings on June 12 and 13 with officials of FEC, USAID and Technical Support Services. The writer wishes to express his appreciation for the cooperation he received during the visit.

Internal controls not isolated from good management

Everybody recognizes that an enterprise must have good internal controls, but the concept is difficult to define. It includes the prevention of fraud, protection of assets and the production of accurate accounting records, but it also must include reasonable assurance that all top management policies are faithfully executed and decisions at levels of the hierarchy are made congruent with management objectives

The role of internal auditing

Assurance the controls are working

Simply put, the internal auditing department's key mission is to help assure top management that the internal and management controls are functioning.

Observation and advice with no authority to effect changes

It is important to recognize that the internal and management audit department investigates, observes and recommends, but is has no authority to change anything. Change is a management prerogative.

Is FEC's role in municipal development changing?

In FEC's booklet entitled "Textes Portant Réorganisation du Fonds D'Equipement Communal" the section on general policies (Declaration de Politique Generale) states that FEC's key objectives are to:

- Promote priority municipal investments
- Improve municipal financial performance
- Optimize the use of municipal resources
- Preserve FEC's financial viability

Section A1 reinforces the first three objectives by stating that FEC's principal activity is to finance economically and financially viable municipal investments.

There is a teaching, guidance role for FEC in these objectives. How many municipalities know how to "prioritize" investments? How many know how to "improve financial performance" or "optimize use of municipal resources" or "discover financially and economically viable investments?" Many, perhaps most, municipalities need help in learning to spend there increasing income wisely and FEC appears to be the government's vehicle to provide this help.

The terms of reference of this mission and discussion with FEC officials indicate that FEC's role might change. FEC's recent conversion to an autonomous, general purpose bank will allow it to diversify its products and compete with commercial banks. This paper will view FEC's internal and management controls from the standpoint of its role as stated in its currently active general policies.

Principal achievements of this report

The field work consisted of working daily with the management auditor for 7 man days plus 4 man days of discussions and report writing for a total of 11 man days of work in Morocco. Seven man days of investigations with appropriate officials are not sufficient for detailed reviews and diagnostics of FEC in all areas of operations. However, this report achieves the following:

1. Clarification of the concept of internal controls, management controls, the role and limitations of an internal and management control department and internal and management control reviews.

2. Exposing the newly hired management control specialist to current best practices in conducting internal and management control reviews and best practices in reporting thereon.

3. Conducting investigations sufficient to provide initial, concrete suggestions for improvements in municipal lending, the budget process and FEC accounting (Section II), the more sensitive areas of FEC's operations.
4. Discussions with appropriate FEC officials of internal and management control recommendations.

5. Preparation of a two year implementation plan (Section III).

6. Preparation of a sample internal and management control questionnaire and work program (Annex A)

Reviews of internal controls are time consuming

In order to be accurate and fair, internal control reviews are time consuming. A review of internal controls must be based on sufficient evidence, especially if changes will be recommended.

No tradition of internal auditing or written procedures manuals

During the last quarter of 1995 the Internal Auditor left FEC and his two assistants were reassigned to other positions. Not only did all internal auditing stop in 1995, there never has been a written internal audit tradition with work programs, scheduled work or a formal report process with a management follow up.

Scope of work

The initial meeting with FEC identified municipal loans, the budget process and FEC accounting as the most significant areas for review. It was agreed that it was better to be thorough in a few items rather than superficial in many and the mission should consist of an internal audit from a management viewpoint conducted by the mission consultant. The objective was to expose the mission counter parties at FEC to an internal control review process, producing initial recommendations in the areas reviewed.

Overview of results

Results of operations

A quick review of the results of operations reveals a low profitability during the last three years 1994-1996. FEC's growth has been generated principally from new debt financing. Without an adequate level of earnings, the cash flow from loan collections will be used to pay current expenses and repay debt, with very little left to make new loans.

Need to strengthen internal controls

There is a need to strengthen internal controls surrounding the granting, disbursing and collection of municipal loans and improve budget/actual reporting.

Internal control review recommendations

Section II (pages 9-15) of the report describes the findings of the mission and includes recommendations to improve internal and management controls in municipal loan processing (7 recommendations), loan disbursing (4 recommendations), loan collections (3 recommendations), loan agreements (4 recommendations), the budget process (5 recommendations), FEC accounting and mechanization (3 recommendations)and three general recommendations.

Implementation program within FEC

The report describes in Section III a 10 point two-year implementation program that will require the hire or transfer of two staff to the internal and management control department. This program recommends that the internal control activities report directly to top management and includes the preparation of procedure manuals, participation in the budget process, internal review questionnaires and work programs and the need to prepare an annual work plan. It describes the internal audit cycle and the importance of top management response to recommendations of the internal audit department together with a program of outside consultant assistance during the implementation. Annex A offers a sample questionnaire and work program for municipal loan disbursements.

FONDS D'EQUIPEMENT COMMUNAL (FEC)

REPORT ON INTERNAL CONTROLS - FEC (FA -B.32)

I. GENERAL CONSIDERATIONS

Introduction

This report is based on the findings of a mission to Rabat, Morocco from May 31 to June 14, 1997 by Peter L. Doty, pursuant to the terms of reference dated May 10, 1997 under contract 608-C-00-96-00000, related activity FA-B 32 Internal Controls-FEC. This report is based on interviews with FEC officials during the period June 2 to June 11, 1997 and discussions of findings on June 12 and 13 with officials of FEC, USAID and Technical Support Services. The writer wishes to express his appreciation for the cooperation he received during the visit.

Internal controls not isolated from good management

Everybody recognizes that an enterprise must have good internal controls, but the notion is difficult to define. It includes the prevention of fraud, protection of assets and the production of accurate accounting records, but it also must include reasonable assurance that all top management policies are faithfully executed and that decisions at all levels are taken based on an proper authorizations system and are congruent with management objectives.

The writer wishes to emphasize that the following paragraphs are illustrative and are not examples of findings of the mission.

Suppose, for instance, that FEC made a loan to a municipality to finance a budgetary deficit. The loan files indicate the finances of the municipality are very healthy and it would have no difficulty in repaying the loan. The loan was duly and correctly disbursed, approved by the credit committee, and three years later it has an excellent record of timely payments. The asset is protected and recoverable, but this loan clearly violates FEC's general policies of making loans for viable, priority investments. The internal auditing department, if there is one, upon discovering this situation, must alert top management. If an additional investigation shows this was not an isolated instance, it could result in significant changes in the loan approval process and perhaps changes in personnel.

Take the same healthy municipality and a priority investment in road paving with the same timely repayments and suppose that a site visit revealed that the municipality used the funds to build a school. The asset is collectible, but the internal controls designed to assure FEC that loan funds are used for the approved purpose are either nonexistent or violated and should be reported to top management when discovered.

Suppose the internal auditor discovers that many loans have delayed disbursements. An investigation shows that FEC did not have enough funds for timely disbursements and it has no procedures to forecast cash flows. The accounting records are accurate and reliable, but the inability to mount non-accounting procedures that assure sufficient funds hampers operations. The solution here is to report this situation to top management and improve financial management controls.

The key question here is whether the discoveries mentioned in the prior three paragraphs should be accidental or whether FEC should consciously achieve a capacity to review all procedures, accounting, non-accounting, financial, managerial, etc. and report the findings to top management. This report adopts a broad, non-limiting approach to internal controls.

The role of internal auditing

Assurance the controls are working

Simply put, the internal auditing department's key mission is to help assure top management that the internal and management controls are functioning. Armed with written procedures manuals, internal control questionnaires and work programs, the department should prepare a work program for the year with rotating tests of transactions, loan files, correspondence and other documentation. A draft of the report of findings with recommendations for improvement is discussed with appropriate personnel of the affected departments, their comments incorporated in the final version and a final report issued to top management.

Remedial action required

If the process stops here with a report that is merely read and filed with no mandate for reform, it will fail and FEC has wasted its investment in internal audit personnel. It must become a custom to require the appropriate officials of departments affected to reply within, say 20 days, to the recommendations including proposed corrective actions. Of course, it will be incumbent on the internal audit department to schedule a follow-up review to be sure they successfully implement the changes.

Observation and advice with no authority to effect changes

It is important to recognize that the internal and management control department investigates, observes and recommends, but has no authority to change anything. Change is a management prerogative. Top management receives the report with recommendations and possesses the exclusive right to order change. Of course, if the internal control department develops a reputation for astute, useful suggestions, the affected departments will begin to take corrective action before it receives an order.

An example from this report illustrates this principle of observation and advice with no executive authority. Section II below contains an observation that one loan reviewed for a project with a 10-year negative cash flow, might not comply with FEC's stated objectives for municipal strengthening through financially viable investments (page 9). It is outside the terms of reference of the internal control department, and indeed, of this report, to search for more viable projects or reorient FEC's investment priorities.

Training for entering executives

Another possible mission for an internal audit department is a training ground for entering executives. Within a short period of time an entering executive will observe all phases of FEC's operations. The mission leader was particularly pleased to see his counterparts taking copious notes during the review. More than once they expressed their appreciation for the exposure to FEC's operations that they have not seen before that would be useful in their work.

These ideas of internal controls and the intimate relationship to management controls and the role of internal audits were discussed in a management meeting during the second day of the mission. The finance director commented in a meeting with USAID officials at the end of the mission that this discussion helped clarify these concepts and the methodology adopted for the mission enabled them to understand better how to conduct and increase their appetite for internal control reviews.

Is FEC's role in municipal development changing?

FEC's current general policies

In FEC's booklet entitled "Textes Portant Réorganisation du Fonds D'Equipment Communal" the section on general policies (Declaration de Politique General) states that FEC's key objectives are to:

- Promote priority municipal investments
- Improve municipal financial performance
- Optimize the use of municipal resources
- Preserve FEC's financial viability

Section A1 reinforces the first three objectives by stating that FEC's principal activity is to finance economically and financially viable municipal investments.

There is a teaching, guidance role for FEC in these objectives. How many municipalities know how to "prioritize" investments? How many know how to "improve financial performance" or "optimize use of municipal resources" or "discover financially and economically viable investments"? The significant changes in federal municipal entitlements by which the Value Added Tax (VAT) is now awarded based on population and not a federal evaluation of municipal needs, grant municipalities more autonomy and, for many municipalities, more income. Many, perhaps most, municipalities need help in learning to spend this additional income wisely and FEC is the government's vehicle to provide this help.

FEC's possible conversion to a bank

The terms of reference of this mission and discussion with FEC officials indicate that FEC's role might change in that the recent conversion to an autonomous, general purpose bank will allow a diversification of products and competition with commercial banks. FEC's response to this new authorization will be the theme of a major Booz Allen study scheduled to begin in July 1997.

The focus of this report

This paper takes no position whether the entrance of commercial banks in municipal financing is a threat to or a reward for FEC's municipal strengthening efforts or how its organization and controls should adapt to a conversion to another commercial bank with a municipal lending specialization. This paper will view FEC's internal and management controls from the standpoint of its currently active general policies.

Principal achievements of this report

Time analysis

The field work consisted of working daily with the management auditor and two other newly hired executives for 11 man days as follows:

		No. days
Field work-		
A brief overview		0.5
Municipal loans		4.0
The budget process		1.0
FEC accounting		0.5
FEC mechanization		0.5
Legal matters		0.5
	Total	7.0
Discussions and preparation-		
Implementation discussions		1.0
Review of existing reports		1.0
Report writing and discussions		2.0
	Total	4.0
Total man days		11.0

Principal achievements

Seven man days of investigations with appropriate officials are not sufficient for detailed reviews and diagnostics of FEC in all areas of operations. However, this report achieves the following:

1. Clarification of the concept of internal controls, management controls, the role and limitations of an internal and management control department and internal and management control reviews.

2. Exposing the newly hired management control specialist and two other employees assigned to work with the mission to current best practices in conducting internal and management control reviews and best practices in reporting thereon.

3. Conducting investigations sufficient to provide initial, concrete suggestions for improvements in municipal lending (the major focus), the budget process and FEC accounting (Section II), the more sensitive areas of FEC's operations.

4. Discussions with appropriate FEC officials of internal and management control recommendations.

5. Preparation of a two-year implementation plan (Section III).

6. Preparation of a sample internal and management control questionnaire and work program (Annex A)

Scope of work

The initial meeting with FEC management identified municipal loans, the budget process and FEC accounting as the most significant areas for review. All agreed that thoroughness in a few items was better than superficiality. The mission should consist of an internal audit from a management viewpoint conducted by the mission consultant. The objective was to expose the mission counter parties at FEC to an internal control review process, including initial recommendations in the areas reviewed.

Overview of results of operations

A quick review of the results of operations reveals a low profitability during the last three years 1994-1996. This unsatisfactory performance, coupled with a debt to net worth ratio of 19 to 1, threatens FEC's viability as a replicable and consistent source of municipal financing. FEC's they have generated growth principally from new debt financing. Without an adequate level of earnings, the cash flow from loan collections will be used to pay current expenses and repay debt, with very little left to make new loans.

Summary of results of the internal control review

As mentioned earlier in this report the concept of internal controls is very broad. It includes providing assurance that management policies are being followed, detecting efficiency improvements, asset protection, improving the information system, and detecting opportunities to increase revenues or reduce expenses. Although this report is based on only seven field work days, Section II of this report detected examples of each and presents 35 recommendations in the areas of municipal lending, the budget process and FEC accounting. Some of the principal recommendations referenced by the number appearing in Section II are the following:

<u>Faithful execution of top management policies</u>

1. FEC should consider developing a policy of refusing to lend in many cases until the municipality agrees to carry out a financial action plan.

2. FEC should decide on the importance of past financial history in the decision to grant a loan.

3. There is a need for a policy on financing projects with negative cash flows.

   At first glance one might be tempted to view these recommendations as a managerial diagnosis devoid of any internal control content. In fact, there is a direct link to internal controls. An important goal of FEC, as stated in its charter, is to strengthen municipalities. Creating municipal debt that claims future revenues is not a prima facie proof of municipal strengthening. Maybe the municipalities should improve their own administration and improve their billing system, property, and accounting records before they borrow.

Assume that FEC had a detailed municipal lending operations manual that reinforced and delineated non-lending strengthening opportunities or described when lending should be subject to a municipal resolve to improve its own operations. If a review of loan files by an internal auditor detects many cases when this manual was not being followed, there is a duty to report these top management policy violations.

11. Project files should clearly show accumulated project expenditures and how FEC applies the municipal participation in the project.

15. The loan agreement should clearly state what percentage of eligible expenditures FEC is financing and clearly describe how FEC will disburse these funds.

<u>Opportunities to improve efficiency</u>

8. Consider changing the tranche system to a system of recording a disbursing loan until it completes followed by a conversion to a loan in repayment.

12. Consider changing annual payments to quarterly payments matching the quarterly VAT payments to municipalities.

14. Dialogue with the Treasury Department to reduce the transit time of municipality payments and introduce more clarity in their remittance slips.

<u>Protect assets</u>

10. Oblige the municipalities to provide actual proof of contractor payments including a copy of contractor's invoices.

16. The loan agreement should state that the government guarantees payments, if, indeed there is a guarantee.

<u>Improve the information system</u>

6. Start a database of municipal finances, at least for FEC clients

10. Oblige the municipalities to provide actual proof of contractor payments including a copy of contractor's invoices.

27. Initiate a budget by cost center.

30. Redesign the chart of accounts to provide for accounts by cost center.

<u>Increase revenues or reduce expenses</u>

7. As a significant additional revenue source, consider charging municipalities for processing the loan and supervising its disbursement.

II. INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS (JUNE 1997)

Introduction

Detailed reviews of internal controls are time consuming

To be accurate and fair, internal control reviews are time consuming. A review of internal controls must be based on sufficient evidence, especially if it recommends changes. For instance, as mentioned below in the section on loan processing, two credit files were reviewed in detail. In the first case FEC approved a small loan to a municipality with a history of deficits, but with an expectation of increased VAT revenues that permitted the amortization of the loan. In the second case, the municipality had a healthy financial performance that showed an ability to finance a deficit producing sports complex.

It would, obviously, be incorrect to conclude that half the loans are to municipalities with deficits and the other half are loans for projects with a negative cash flow based only on a review of two loans. The two files examined could be isolated instances. A more definitive conclusion can emerge only from a significant increase in the sample, perhaps 50 to 75 of the 500 loans in FEC's loan portfolio. In fact compiling all loans to discover the total impact of FEC's loans on municipal finances may be interesting, a piece of work that could easily require two weeks to prepare.

This mission could not dedicate the time for such an exhaustive review, but an internal audit department could. Another factor affecting time consumed in internal control reviews is the absence of written procedures manuals. The mission could have covered more ground if it could have compared its findings with procedures manuals.

No tradition of internal auditing or written procedures manuals

During the last quarter of 1995 the Internal Auditor left FEC and his two assistants were reassigned to other positions. Not only did all internal auditing stop in 1995, there has never been a written internal audit tradition with work programs, scheduled work or a formal report process with a management follow up.

There has been a partial reaction to the need to reinforce internal controls. In April 1997, FEC hired a management auditor (control de gestion) to work with the Director of Finance. He has issued four reports on budgets, short-term investments, the financial situation of the Marrakech bus company (a problem loan) and the need for internal controls and procedures manuals. Except for a lending procedures guide prepared for municipal borrowers, FEC has no written procedures manuals.

This new employee stated he was waiting for this mission to help define his role as a management auditor and his proclivity for evaluating procedures affected the scope of work of this mission.

Need to strengthen internal controls

There is a need to strengthen internal controls surrounding the granting, disbursing and collection of municipal loans and improve budget/actual reporting. The rest of this Section describes the internal controls presently in force and makes 35 recommendations for improvements in the areas of municipal lending, FECís cost of funds and borrowings, the budget process, and FECís accounting and mechanization.

Municipal loans

Brief description

As of December 31, 1996, municipal loans totaling DH 3,984 million (US$ 428 million at DH 9.3 per US dollar), approximately 83% of FEC's assets. During 1996, FEC placed approximately DH 931 million (US$ 100 million) new loans.

Loan processing

A. Findings

The mission reviewed two credit files in detail. The first, 1-Tizo/96 was a DH 347,000 (US$ 37,300) central market (souk) for the municipality of T'Zounine and the second was a sports complex (1-Men.Guel/97) costing DH 12,420,000 (US$ 1,335,000) for the municipality of Marrakech.

The financial analysis of T'Zounine revealed a three-year history of deficits. FEC granted this loan based on forecasts of increased Value Added Tax entitlement for 1997 that should provide enough additional income to repay the loan, and the fact that the loan was very small. The point here is that a history of good management was not a requisite to qualify for a loan.

The projections of revenues and expenses of the sports complex revealed deficits for the next ten years but Marrakech's finances were sufficiently robust to absorb the considerable drain on municipal finances. Here FEC financed a low priority project that weakened not strengthened Marrakech's financial position.

The credit officials interviewed explained that there is not a sufficient demand for loans now and FEC must finance where it can. As a result FEC has not developed a rationale for setting priorities for municipal loans by region, by size of municipality or type of project. After disbursing a loan FEC does not track municipal results of operations either at the municipal level or does it receive data on the cash flows of the projects financed. FEC officials see the need to create a database of municipal finances, at least for those municipalities it finances.

FEC's charter states FEC should finance priority projects, aid municipalities in preparing projects and to be an agent for strengthening municipal finances. FEC does help municipalities prepare projects and they helped T'Zounine redesign its souk. A question does arise whether FEC finances only priority projects. Officials agreed they should do much more municipal administration consulting, but cannot afford the personnel required for this activity.

The consultant mentioned that the activity of municipal strengthening through financial action plans is an important activity in other countries. These programs, often a requirement before a loan is granted, have been financed by a national program or as part of a World Bank loan.

Currently, FEC does not charge municipalities to evaluate loan requests, nor does it charge for supervising the disbursement of the loan.

B. Recommendations

1. FEC should consider developing a policy of refusing to lend in many cases until the municipality agrees to carry out a financial action plan.

   Very often municipalities are lax in collecting revenues. Its billing system may be antiquated; property records may be outdated or incomplete. A financial action plan financed by the national government and administered by FEC might produce a significant effect on municipal income and reduce or eliminate the need for a loan to finance priority projects.

2. FEC should decide on the importance of past financial history in the decision to grant a loan.

   Showing an adequate financial administration should be a requisite to grant a loan. It does appear risky to grant loans based on expected improvements.

3. There is a need for a policy on financing projects with negative cash flows.

   FEC should promote projects that foment increased revenues .

4. There will soon be a need for a policy on what portion of municipal needs FEC should address, since it does not have resources for all municipal requirements.

   All major projects such as water supply and electrification have elements financed from increased future revenues such as water and electric meters, secondary water and electrical connections.

5. FEC should develop a rationale for prioritizing loans to assure transparency and fairness in allocating its lending resources.

   The time will soon come when demand for loans will exceed the supply especially after the foreign loans disburse and begin repayment.

6. Start a database of municipal finances, at least for FEC clients

   This database will be invaluable in the analysis of municipal finances and tracking trends.

7. As a significant additional revenue source, consider charging municipalities for processing the loan and supervising its disbursement.

Loan disbursements

A. Findings

FEC disburses its loans in tranches. Each tranche is treated as a separate mini-loan with a separate amortization table requiring the signatures of the municipality, FEC, the Ministry of the Interior and the Ministry of Finance. The registry of these signed amortization tables with the Finance and Interior Ministries constitute the basis for annual municipality budget appropriations that are approved by these ministries. Some loans have six tranches with six separate amortization tables and many have three tranches.

So far all FEC municipal loans provide for a fixed rate of interest so that the original amortization table is valid for the life of the loan. FEC is considering variable interest rate loans. A change in interest rate would invalidate the original amortization table. FEC should begin designing a system that does not require re-filing for all tranches each time the interest rate changes.

FEC disburses a tranche based on estimated future municipal disbursements. Since each tranche requires its own amortization table, there is a temptation to make these tranches large and infrequent. FEC has not developed procedures to reimburse municipalities based on actual eligible expenditures.

The disbursement files contain no documentation of actual expenditures other than municipal provisions. FEC officials stated that these municipal provisions are solemn documents that obviate the need for original contractor invoices, but the consultant does not agree with this position. The files should contain contractor bills.

FEC has initiated a policy of financing 85% of project costs that will decrease in 1998 to 80%. The application of the municipal contribution toward the project appears to occur at the end of the disbursement period.

B. Recommendations

8. Consider changing the tranche system to a system of recording a disbursing loan until it completes followed by a conversion to a loan in repayment.

   FEC estimates it has made approximately 500 loans, but the administrative burden of tracking and accounting for some 2,000 amortization tables is immense and requires simplification.

9. Consider reforming the system of perpetual advances to a system of reimbursement for FEC's participation in actual municipal disbursements.

   FEC finances the municipalities before they spend, often for six months expected disbursements.

10. Oblige the municipalities to provide actual proof of contractor payments including a copy of contractor's invoices.

11. Project files should clearly show accumulated project expenditures and how FEC applies the municipal participation in the project.

Loan collections

A. Findings

Since all municipalities and FEC have an account at the Treasury General, collections should be a speedy routine procedure of a transfer from a municipality account to FEC's account. In fact some payments require 45 days to process, an unwarranted delay. The Treasury General remittance slips of municipal payments do not clearly specify which loan amortizations are being paid. FEC employees invest many unnecessary hours identifying payments and applying them to the proper accounts.

All municipal loans are paid in annual installments on the anniversary date of each tranche. More frequent payments, perhaps quarterly, not only might ease the cash flows of the municipalities but would give FEC earlier notice of payment difficulties.

FEC does not send payment reminders before an installment is due, nor does it acknowledge receipt when it is paid.

B. Recommendations

12. Consider changing annual payments to quarterly payments matching the quarterly VAT payments to municipalities.

13. Send remittance advises to clients showing how the payment was applied by FEC.

14. Dialogue with the Treasury Department to reduce the transit time of municipality payments and introduce more clarity in their remittance slips.

Loan agreements with municipalities

A. Findings

Recently issued loan agreements reviewed show a need for a general revision. The contracts do not mention the percentage of project costs FEC will finance. The agreements contain the expected project costs and what will be the expected FEC and municipal participation. It does not say how FEC's loan will be affected if actual project costs contracted are less than expected.

The loan agreements do not mention the loan guarantee of the national government. In fact it is not clear how the government issues its guarantee. The Interior and Finance ministries sign the loan agreements besides FEC and the municipality, a total of four signatures, but this document is not the actual loan but simply an agreement to lend. The loan amount becomes established upon disbursement of each tranche and the preparation and execution of the amortization table that is not a part of the loan agreement. There is no mention of a state guarantee on these amortization tables.

It appears the change in VAT municipal entitlement may have changed the nature of the state guarantee. Before the reforms the VAT tax was used to cover municipal deficits. The state having signed the loan agreement and the subsequent amortization tables for each tranche, and further having an overview to be sure each municipality entered that year's amortization in its budget, then apparently acquired an obligation to cover the municipality's deficit, thus assuring sufficient funds to pay FEC.

The reforms reserved 5% of VAT for municipal emergencies and established municipal VAT entitlement based on population and has eliminated its deficit coverage obligations. Now, the state's obligation may be its overview function to insure FEC's annual amortizations are included in each municipality's budget.

B. Recommendations

15. The loan agreement should clearly state what percentage of eligible expenditures FEC is financing and clearly describe how FEC will disburse these funds.

16. The agreement should state that the government guarantees payments, if, indeed there is a guarantee.

17. In addition, the agreement should require the municipalities to:

    a. Send evidence of all payments to contractors including the contractor's request for payments.

    b. Include the amortizations in the municipal budget.

    c. Send annual financial statements including the formal budget execution information to FEC.

18. Consider enabling municipalities to authorize the Treasury General to withhold VAT entitlement to pay FEC's loans instead of a federal guarantee.

FECís cost of funds and borrowings

A. Findings

FECís operations depend on borrowed funds . At the end of 1992 borrowed funds were 95% of assets with little change through the end of 1996 (94% of assets). Small changes in cost of borrowings, therefore, will have a major impact on operations. From 1992 to 1996 the composition of borrowings has changed significantly between local and foreign borrowings. In 1992 local and foreign borrowings were 89% and 6% of assets respectively and by the end of 1996 these ratios changed to 66% and 28% respectively. As foreign loans become an increasing part of FECís operations, FECís cost of funds become more volatile.

At first glance, a foreign 7.5% loan in dollars appears more attractive than 12% local financing, but foreign financing many not be so attractive in the long run. First, most foreign loans carry variable interest rates. If FEC prices its municipal loans with a 2 point margin over the initial foreign loan interest rate, a 1/2 point increase in the cost of borrowing degrades this margin by 25% if it is not passed on.

FEC should consider other costs, such as a commission on unused funds and much more importantly, the costs of exchange rate fluctuations. If the Moroccan Dirham gains against the US dollar, as it did from the two-year period ending December of 1995, FEC benefits. During 1996 and the first 10 months of 1997, the Dirham devaluated and drove the effective cost of foreign borrowings to unprofitable levels as shown in the following table:

Effective interest rate of a 7.5% US dollar loan

Year	Dirham Devaluation (revaluation)	Effective Interest Rate
1994	(7.43%)	(0.5%)
1995	(5.39%)	1.7%
1996	4.14%	12.0%
1997 *	9.76%	18.0%

* to October 1, 1997

Irrespective of who absorbs the exchange rate risk, FEC or the Moroccan government, from a financial point of view, the effective cost of foreign borrowing fluctuated widely every year for the last 4 years, ranging from no cost in 1994 to 18% during the first 9 months of 1997. As foreign borrowings become an ever increasing portion of total debt, FEC will flourish or flounder with its currently fixed rate 13% municipal loans depending on the exogenous behavior of the US dollar.

Of course, budgeting and projections become almost impossible if the most significant item to forecast is the Dirham/US dollar exchange rate.

As stated above in the prior Section, although FECís internal policies permit variations in the interest it charges municipalities, the cumbersome process of registering amortizations to maturity with government authorities creates immense administrative burdens and is not practical at this time.

B. Recommendations

It is beyond the scope of this study on internal controls to analyze how FEC can shield itself from the effects of a fluctuating US dollar. There are many areas for top management to consider such as:

19. Maintaining monthly statistics on the true cost of foreign borrowings

20. Reconsider the advisability of foreign borrowings to finance fixed rate municipal loans

21. Study ways to increase interest rates to municipalities to a point where they provide an acceptable margin over the cost of local borrowing

22. Institute procedures that ease the administrative burden of changing municipal interest rates

23. Consider the possibility of making dollar loans to municipalities

24. Consider the possibility of indexing municipal loans to inflation as a partial buffer to help carry the costs of currency devaluation

The budget process

A. Findings

FEC's charter requires an annual budget for the next year to be prepared in October of each year. The budget expense categories are grouped that differs from the accounting chart of accounts, making comparisons between actual and budget unnecessarily complicated. There are timing differences between the accounting records that contain provisions for costs based on receipt of invoices and the budget department that enters items when paid.

The format of the monthly budget reports is difficult to interpret or detect variations each month. The monthly report compares accumulated expenditures against the annual budget and shows the percentage of budgeted amounts spent. The presumption here is that after three months or 25% of the year, 25% of the budget should be spent. Having a monthly budget that recognizes that all expenses to not flow evenly during the year would be better. Year end bonuses, for instance, will not be 25% spent by the end of March.

FEC has no cost center accounting in the budget or in the accounting records. Salaries for all departments appear in one account, making it difficult to attach responsibilities for cost overruns or savings. Finally, it appears to be a waste of time for a budget department to compile the monthly report when the accounting software can enter the budget and prepare detailed monthly comparisons of budget to actual automatically from the computer.

B. Recommendations

25. Conform budgeted expenses to the chart of accounts.

26. Produce a monthly and year-to-date comparison of budget to actual

27. Initiate a budget by cost center.

28. Begin a procedure of comments on possible cost overruns.

29. Let the computer produce the comparison between budget and actual since the software has this capability.

FEC accounting and mechanization

A. Findings

The accounting software program seems adequate. However, its budget accounting capability is not being used. Loan servicing is prepared on four Lotus spread sheets and is unwieldy and will soon be replaced. The conversion from Lotus spreadsheets to a UNIX based dedicated program for loan servicing is progressing satisfactorily and will be completely implemented by the end of the year. A computerized source of funding application will be ready by year end and FEC hopes to install a computer aided decision system with a grant from USAID and TSS/Maroc.

The chart of accounts does not provide for accounting by cost centers.

B. Recommendations

30. Redesign the chart of accounts to provide for accounts by cost center.

31. Convert to the statutory banking chart of accounts in ways that will incorporate FEC information needs.

32. Install the budget in the accounting program and prepare monthly computerized comparisons with actual figures.

Other - general

33. Consider visiting the Municipal Development Fund of the Paraná state in Curitiba Brazil to see a very successful fund close up.

    The Municipal Development Fund was created in connection with a 1988 World Bank project in the state of Paraná. Its key features are the creation of a Municipal Development Fund that lent the proceeds of the World Bank loan matched by an equal federal capital contribution to the Fund and the use of part of the loan to finance grants to municipalities for technical assistance, principally financial action plans and property registry modernizations awarded to local consulting firms. The Fund charges a market rate of interest for financially viable priority projects and the municipalities repay via state treasury withholdings of municipal entitlements. Many loan projects were denied until the municipality prepared a financial action plan and displayed a capability for efficient management.

34. Consider contracting a municipal loan finance specialist to help with FEC loan servicing and conversion from the present tranche system to a loan in disbursement- loan in repayment system.

35. Create the Department of Internal and Management Control (DIM) reporting to the Director General and appoint the recently hired management auditor (control de gestion) as head of department.

III. IMPLEMENTATION PROGRAM (JUNE 1997)

Implementation program within FEC

The implementation program consists of the following elements:

1. Transfer the management auditor from the department of finance to report directly to the Director General. — July 1997

   Now, the management auditor reports to the Director of Finance. It is a commonly accepted precept that the auditor should have unrestricted access to all divisions and be granted the authorization to freely report to top management his findings, including his assessment of the Finance Division. This transfer should occur when possible and no later than the end of July 1997.

2. Contract two assistants for the DIM — September 1997

   The management auditor cannot do the work required by himself. Much work needs to be done, starting with the preparation of procedure manuals for all divisions and the preparation of internal control questionnaires and work programs. The management auditor feels, and the mission leader concurs, that two persons are needed and could be recruited by September 1997. These assistants should have at least two years experience with an inter-national auditing firm.

3. The management auditor will continue the work of diagnosing and familiarization of each department of each division (direction). — July - Sept. 1997

   This work can be completed by the time the two additional staff members are recruited.

4. The management auditor should participate part time in the budgeting process for 1998. — Aug. - Nov. 1997

   His work consists in helping to redesign the budget forms to conform to the chart of accounts, coordinating the conversion from the present report a computerized report that compares budget with actual and observing how each division prepares its budget. The budget process begins in August and ends in October of each year. Following the submission of the budget in October, the DIM should prepare a budget manual during November.

5.	There should be a formal response to the reports prepared by the Control de Gestion on: Budgets Internal controls Short term investments Financial situation of the Marrakech bus company	September 1997

6. Begin the redesign of the chart of accounts which will incorporate cost centers matching the organizational chart and the new banking accounting regulations. — July - Dec. 1997

7. Preparation of procedures manuals — Sept. 1997-Feb. 1998

   Each department of each division will need a procedures manual that describes each procedure and assigns responsibility for each procedure. This process consists of (1) design and drafting, (2) Discussion and approval, (3) Issuance and introduction meetings. The manuals should be issued in loose leaf binders that ease subsequent additions and amendments. Given the absence of any written manuals and a set of job descriptions, this task could take 6 months, 2 months for each of the three phases.

8. Design internal control questionnaires and work programs based on the procedures manuals. — Feb. 1998-Aug. 1998

   The questionnaires and work programs should cover the areas noted on the next page:

   a. Cash in banks and petty cash

      Petty cash documentation, frequency of reimbursement, proper authorizations, respect of maximum disbursement authorization not needing a check, surprise petty cash count.

      Bank account reconciliations timely, investigation of unusual reconciling items, review of check endorsements, physical control of checks, all signers authorized, control over issuance of checks, collectible

   b. Non-municipal receivables

      Employees- authorized loans, timely payments, interest rate calculations, incidence of loans to ex-employees

   c. Municipal loans
      Granting
      Disbursement (see Annex A)
      Collection
      Completeness of loan agreement
      Completeness of project files and documentation
      Incidence of executing federal guarantee
      Non-performing loans
      Check on calculation of reserve for doubtful loans

Compliance with FEC objectives and policies
Interest income calculation
Random selection of project for physical inspection

d. Fixed assets
Acquisition in budget
Compliance with FEC procurement requirements
Calculation of depreciation
Proper identification
Physical inventory

e. Other assets
Prepaid expenses
Deposits
Supplies

f. Loans payable
Authorized
Compliance with loan agreements
Compliance with FEC margin requirements
Interest expense calculations
Proper classification long-term short-term

g. Accounts payable and accrued expenses

h. Payroll and fringe benefits
Salaries authorized
Social security calculation
Pay raises authorized
Completeness of personnel files
Assurance that payments are for bonafide employees

i. Review of transactions
Randomly selected
Complete documentation
Proper account charged
Budget allocation
See canceled check and endorsement

j. Special department programs (some examples)
Data processing
Treasury
Site visits

9. Implement the pilot internal review cycle. Feb. - Aug. 1998

This work should begin immediately following the issuance of the procedures manual with a pilot internal review as each internal review questionnaire and work program is prepared.

These questionnaires and work programs should cover the following areas:

a. Perform internal and management control work
b. Draft internal control report
c. Discuss work and recommendations with affected officials
d. Incorporate comments of officials
e. Issue report to Director General
f. Corrective action program request
g. Formal reply of affected officials containing the action program to correct the situation
h. Follow-up on status of corrective action by DIM

10. Implement the 2nd internal review cycle. Sept. 1998-May 1999

This phase will provide an opportunity to revise the work programs, assess compliance with report recommendations, prepare a review agenda and establish a work routine designed to cover all areas in a six-month period.

External technical assistance

Internal control strengthening by external consultant

The timing of additional external consultant assistance must depend on FEC's reaction to the need for additional personnel in the internal and management control department and when FEC decides to assign the newly hired management control specialist to full time internal control review duties. They have asked that he participate in the four-month Booze Allen study, so progress in internal control strengthening is likely to be spotty until this work finishes. Assuming FEC musters the will and personnel resources required, the following program of outside consultancies would be productive:

1. 1st. follow-up mission October 1997

The purpose of this mission is to assist in the preparation of the procedure manuals and provide some guidance in the design of internal review questionnaires and work programs. In addition to discussing procedure manual and work program preparation methodology, the mission leader will prepare at least one procedure manual in the area of municipal lending, design the related internal control review questionnaire and work program and conduct a detailed internal audit with the DIM. This mission would require 3 weeks in the field plus 3 days travel and 5 days following the field work for report writing. This mission should not be scheduled until the middle of active procedures manual preparation.

2. 2nd follow-up mission February 1998

Starting late January or early February, 1998, after the procedures manuals are finished, the outside consultant will review the progress since the prior mission, assist the DIM in the preparation of additional internal and management control questionnaires and work programs and guide the initial pilot internal control reviews, including the preparation of the first reports to top management, guide management's response, and help the affected departments initiate corrective action. This would be an appropriate time to lead discussions on how the Booz Allen study would affect the procedures manuals and the DIM work plan.. This mission would require three weeks in the field plus 3 days travel and 5 days following the field work for report writing, but should not be scheduled until the DIM is ready to begin the preparation of the questionnaires and work programs.

3 3rd follow-up mission

By now the procedures manuals are in place and accepted and the DIM have performed the pilot cycle of internal control reviews. Hopefully, the DIM has acquired a credible reputation for perception and fairness. Now is the time to review the quality of the reports issued during the pilot phase and management's response to these reports, review the quality of the questionnaires and work programs and actively participate in the development of the next review cycle. This mission would require 3 weeks in the field plus 3 days travel and 5 days following the field work for report writing. This mission should not be scheduled until the DIM has completed the pilot review cycle, has issued several reports, and is ready to organize the second review.

4. Final mission June 1999

This mission would concentrate on the reports issued during the second review cycle, focus on how the DIM adapted its routines to changes in FEC's organization, how it responded to a conversion to a bank, and changes to the general policies. The consultant would interview key persons, obtain their reactions to the internal review reports and summarize what procedures were changed during the last year. This mission would require 2 weeks in the field plus 3 days travel and 5 days following the field work for report writing.

Staff training

The new management auditor's five years audit experience with Price Waterhouse & Co. should enable him to recruit and train his two assistants without any outside assistance other than the follow-up missions mentioned in the prior section.

Other consultancies

1. If FEC decides to change its tranche system, they could use a municipal finance loan specialist for approximately 6 weeks to assist in this change.

   This specialist should be familiar with the accounting for disbursing loans until they convert into a repaying loan, the proper documentation of loan files, and proper disbursing loan records and surveillance.

2. FEC will be receiving assistance to implement a computer aided decision system.

3. Booze Allen will begin in early July a 10-man four-month strategic study. They have assigned the recently hired management auditor to work closely with this team.

Estimated two year internal control strengthening budget

Personnel

Besides the management control specialist recently hired, FEC will need two full time assistants for the DIM. They contemplate no other personnel for the next two years.

Equipment

The DIM will need an office and one PC computer connected to the FEC network.

Other costs

Other costs should be very modest such as travel expenses to visit the Agadir office and the costs of periodic site visits to municipalities to physically inspect the project financed and assess the quality of municipal accounting records.

DIM staff training

Assuming successful recruitment of two staff with prior internal auditing experience for the DIM, the newly hired management control specialist, who worked for five years with an international auditing firm, will train his assistants with no need for outside assistance other than that provided by the follow-up missions outlined above.

Fortify internal controls immediately

Properly executed, the preparation of procedure manuals and an internal and management control review program can provide many benefits. The review of job descriptions and the discipline of taking inventory of current duties often detects instances of over staffing. It is likely the costs to revitalize internal controls will be an excellent investment.

ANNEX A

SAMPLE INTERNAL AND MANAGEMENT CONTROLS REVIEW QUESTIONNAIRE AND INTERNAL AUDIT WORK PROGRAM FOR DISBURSEMENTS OF MUNICIPAL LOANS

INTERNAL REVIEW QUESTIONNAIRE **YES / NO**

1. Has the loan been approved by the Credit Committee? _____________

2. Is there a loan agreement signed by FEC, the municipality, the Ministry of Finance and the Ministry of the Interior? _____________

3. Does the loan agreement clearly state what is FEC's participation in the loan? _____________

4. Does the loan agreement state under what conditions FEC will disburse the loan and the municipality's reporting requirements to FEC? _____________

5. Does the loan file clearly show municipal disbursements and totals spent to date? _____________

6. Does the loan file clearly show how the relationship between FEC's disbursements and municipal disbursements? _____________

7. Is the municipal participation percentage in accordance with the loan agreement and FEC established policies? _____________

8. Is FEC disbursing the loan based on a reimbursement at the stipulated % of participation of reported disbursements? _____________

9. Is there an amortization agreement for each tranche signed by FEC, the municipality, the Ministry of Finance and the Ministry of the Interior? _____________

10. Does the date of the amortization agreemen agree with the disbursement date? _____________

11. Has FEC made a site visit prior to each tranche? _____________

12. Does the report of the site visit indicates the relationship between physical _____________

and financial completion?

13. Will the project disburse within the limits stipulated in the loan agreement? ____________

INTERNAL REVIEW WORK PROGRAM **DONE BY**

1. Select __ fully disbursed loans for examination and indicate the basis for selection. ______________________________ ______________________________________ ________________

2. Obtain the loan agreement and trace the loan amount to the Credit Committee authorization. ________________

3. Obtain all amortization tables for each loan tranche and determine that the total does not exceed the amount of the loan agreement. ________________

4. Obtain the latest trial balance of loans and determine that the balance outstanding of each tranche agrees with the amortization table. ________________

5. From the project cost data in the loan file, determine that FEC's participation does not exceed amounts authorized. ________________

6. Trace each tranche disbursement to the Treasury transfer notification and the accounting records ________________

7. Annotate the difference between the date of each transfer and the issue date of each amortization table and determine that the first payment was adjusted correctly. ________________

8. Check the periodic payment calculation in the amortization to be sure the interest rate on the amortization table is the same as the loan agreement. ________________

9. Compare project cash flows reported by the municipality to the projected cash flows in the project file and obtain ________________

explanations for significant variations.

10. Determine that FEC's annual amortization has been included in the municipality budget in the project files. ______________________

ANNEX B

PERSONS MET DURING THE MISSION

Choukrallah Larki	Secretary General
Abdelghani Guezzar	Finance Director
Abdelaziz Ilhami	Chief of Accounting
Mohammed Ayad	Project Evaluation
Kamal Layachi	Project Evaluation
Nadia Mrouhoub	Project Evaluation
Mohammed Akhyat	Project Evaluation
Younes Dinia	Management Auditor
Nawal El Ghaib	Loan Collections
Karim Nasrollah	Chief of Data Processing
Khalid Rhoulami	Treasury Service
A. Belhesen	Source of Funds
Sakina Haloui	Chief of Budget Services
Mohammed Lamzaneg	Personnel
Mrini Khaldoun	Human Resources
Ahmed Nbouh	Chief of Disbursements
M. Mezian	Collections